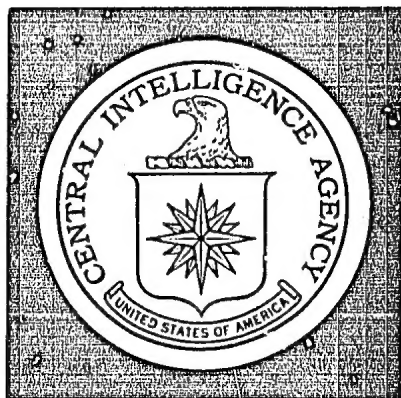


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**DIRECTORATE OF
INTELLIGENCE**

Intelligence Memorandum

Italy Acts To Ward Off Recession

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ER IM 71-146
August 1971

Copy No. **42**

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CENTRAL INTELLIGENCE AGENCY

Directorate of Intelligence

August 1971

INTELLIGENCE MEMORANDUM

ITALY ACTS TO WARD OFF RECESSION

Introduction

1. Unlike other European Community (EC) countries, Italy's economy has slowed down considerably in 1971 and inflationary pressures have eased. Private consumer and investment demand have been stagnant, industrial output has fallen, and unemployment has risen in several industries. Fearing a full-scale recession, the Colombo government on 3 July issued new emergency fiscal measures to stimulate the economy. In the face of substantial popular discontent, the government has moved with greater speed than is characteristic of Italian governments.

2. This memorandum examines recent trends in demand and output as well as specific factors underlying the economic slowdown. It discusses the government's measures to avert a recession and assesses likely short-term economic prospects.

Discussion

Recent Trends in Demand and Output

3. Italy's economy, officially characterized as being "stagnant at a high level of output," can more precisely be described as slowing down and reaching the brink of recession. After an 8.4% spurt in the first quarter of 1970, growth of gross national product (GNP) turned sluggish. Value-added in industry followed a similar course, rising 14.1% in the first quarter of 1970 as recovery from the 1969 strikes set in, but it showed

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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little growth during the rest of the year. Abundant evidence of continued slack appeared in early 1971, and business expectations have become increasingly pessimistic during the past few months.

4. Excess liquidity in the banking system -- a prime indicator of slack investment demand -- reached a record peak in March 1971 (double its level a year earlier) and remained unusually high throughout the spring.^{1/} The ample supply of available funds still persists despite somewhat lower domestic interest rates since early April 1971, when the basic discount rate was reduced from 5.5% to the present 5.0%. Large firms, concerned by sagging profits, have been hesitant to borrow funds, while small and medium-sized firms, which are frequently poor credit risks, have experienced difficulties in obtaining bank loans.

5. The economic slowdown is reflected in a shortfall in anticipated government tax revenues -- about 12% below forecast levels -- in the first five months of 1971. Actually, tax revenues did increase somewhat in January-May relative to a year earlier, but this improvement reflected the fact that collections were atypically low last year as a result of strikes in the Finance Ministry.

6. The slowdown has affected unemployment levels; there was a 19% rise between February 1970 and February 1971. The number of unemployed is particularly high in agriculture and construction. In the chronically depressed textile industry, about one-third of the workers are out of jobs. Underemployment also rose in early 1971, reportedly running some 40% above 1970 levels.

7. In recent months, price pressures have eased after the steep 1969-70 rises, which reflected large wage increases and other cost pressures. In 1969-70 the general price level (as measured by the GNP deflator) rose an average 5.2% annually: wholesale prices, at 6.1%, and consumer prices, at 4.8% (see Figure 1). In contrast, wholesale prices in April 1971 were slightly less than 3% above those of April 1970 and consumer prices, less than 5%. Inflationary pressures at the retail level at least will probably continue to abate over the next few months.

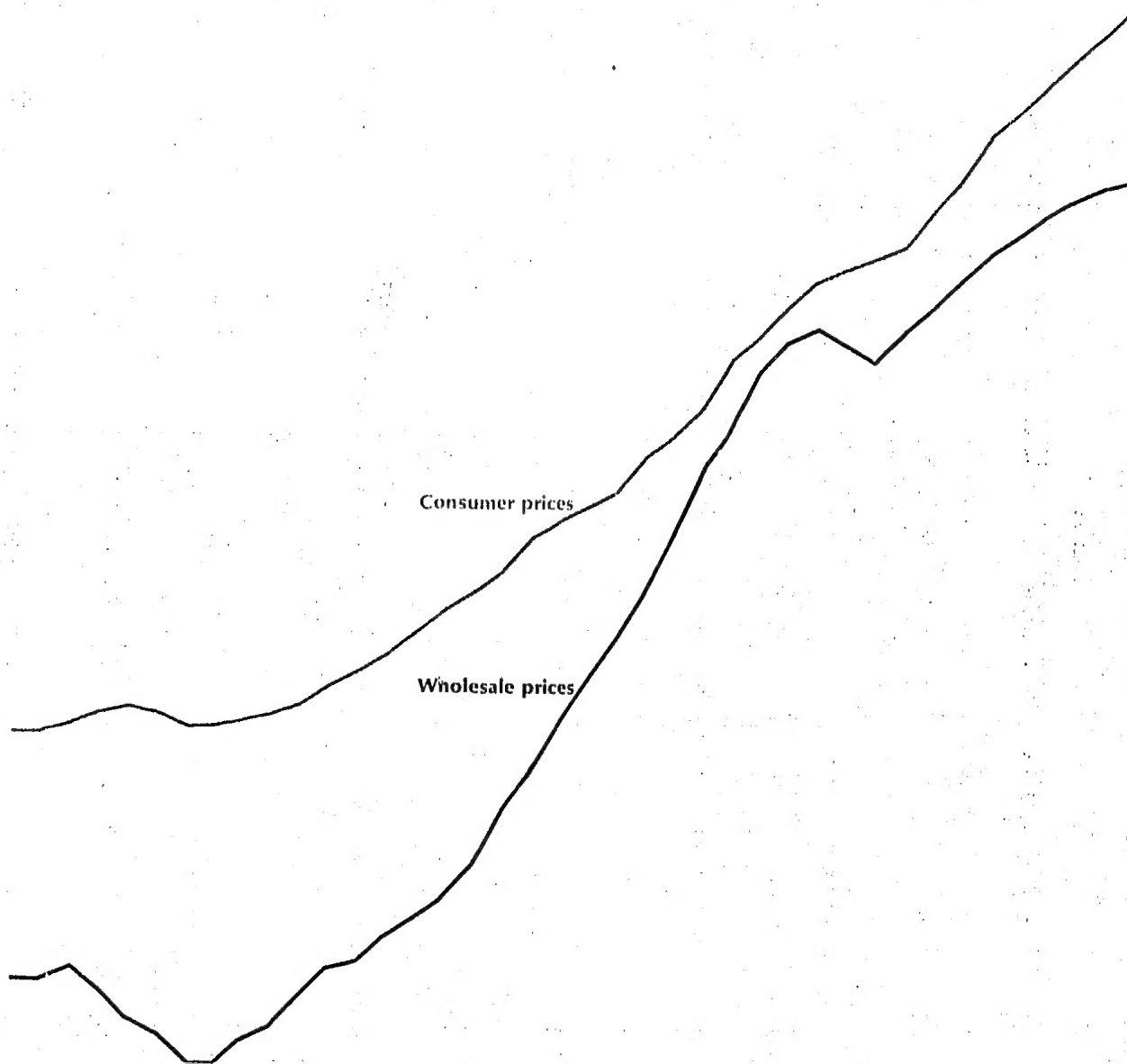
8. The 3.0% drop in industrial production registered in the first five months of 1971 (compared with the same period in 1970) reflects both weak demand and some strike activity. This absolute decline occurred because production of investment goods dropped sharply while output of consumer and intermediate goods showed only slight increases (see Table 1).

1. *The ratio of excess liquidity to total bank deposits was 5.4% in March, compared with only 2.7% a year earlier.*

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Italy: Price Trends



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Table 1

Italy: Industrial Production Index, Seasonally Adjusted

1966 = 100						
	First Quarter 1969		First Quarter 1970		First Quarter 1971	
	Index	Percentage Change ^{a/}	Index	Percentage Change ^{a/}	Index	Percentage Change ^{a/}
General index (excluding construction)	121	8.0	127	5.0	126	-0.8
Investment goods	125	6.8	133	6.4	128	-3.8
Consumer goods	117	9.3	123	5.1	124	0.8
Intermediate goods	118	4.4	122	3.4	123	0.8
Sectoral indexes						
Foodstuffs	115	8.5	120	4.3	127	5.8
Textiles	103	4.0	104	1.0	102	-1.9
Chemicals	119	0	127	6.7	126	-0.8
Petroleum products	126	15.6	148	17.5	150	1.4
Iron and steel	134	7.2	139	3.7	130	-6.5
Machinery	125	8.7	133	6.4	132	-0.8
Transportation equipment	122	15.1	133	9.0	127	-4.5
Electricity and gas	120	7.1	122	1.7	131	7.4

a. Percentage change in index from the first quarter of the preceding year.

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The slack in industrial activity is also evident from lower plant utilization rates for all categories of goods in the first quarter of 1971, as shown in the following tabulation 2/:

<u>1st Quarter</u>	<u>Percent</u>			
	<u>All Industry</u>	<u>Invest- ment Goods</u>	<u>Consumer Goods</u>	<u>Inter- mediate Goods</u>
1970	81.2	83.6	78.2	86.0
1971	78.4	80.5	74.9	85.1

9. The slowdown has been most pronounced in the transportation equipment, petroleum refining, and iron and steel industries. The 6.5% decline in iron and steel output in the first quarter of 1971 reflects the general industrial slowdown, particularly a recession in the construction industry. The slower growth of output of petroleum products dates from mid-1970. Moderated domestic industrial activity; higher local gasoline prices as a result of a tax hike in August; closure of the Sidon, Lebanon, terminal of the Trans-Arabian pipeline; restrictions on production of Libyan crude oil; and increased costs of crude petroleum from both Mediterranean and Persian Gulf sources all worked toward diminishing the growth of output. Chemical production has also slowed considerably. The chemical industry has undergone considerable upheaval because of the state's gradual takeover (through stock purchases) of Montedison -- a group of companies dominating chemical output -- since 1968 and subsequent management difficulties within the group. Textile output, lagging behind all other industries in growth since the mid-1960s, declined in the first quarter of 1971. Heavily dependent on foreign demand (which absorbs about one-third of its output), the Italian textile industry has suffered in both its foreign and domestic markets from low-cost Far Eastern competition.

10. The recession in the construction industry -- now the weakest economic sector -- was apparent in 1970, when housing investment fell sharply and new building starts (residential and non-residential) declined

2. The data on industrial capacity are based on crude surveys. Although their accuracy as to absolute utilization levels is debatable, the trends shown are generally accepted. Recently released government estimates, for instance, put industrial plant utilization levels at 88.5% for the first quarter of 1971, compared with 93.2% a year earlier.

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almost 40% from 1969 levels. The slow-down was partly the aftermath of an artificially contrived building boom during 1968-69 ^{3/} and partly a result of the steep cost rises of the past year. Early in 1971, reportedly one out of every eight construction firms was going bankrupt and unemployment was rising rapidly.

11. Business expectations have grown increasingly pessimistic in the last twelve months. Business surveys show a dwindling share of firms forecasting increases in orders and production and a growing share predicting a decrease (see Table 2). The business community is even more pessimistic about the general economy with 52% of the companies surveyed in May 1971 expecting an unfavorable trend through the summer.

Factors Underlying the Slowdown

12. The currently slack demand and the falling output can basically be traced to labor difficulties that have disturbed the economy since the "hot autumn" of 1969. Since then, Italy has experienced a plethora of general, wildcat, "flash," "hiccup," and "chessboard" strikes for reasons almost as diverse as the types of strikes. Unions have agitated for higher wages and fringe benefits and against both the inadequate social infrastructure and government dallying in carrying out promised reforms. Total man-hours lost to strikes soared from 74 million in 1968 (not a bad year for Italy) to a record high, a world record as well, of 303 million in 1969, then dropped to a still high 146 million in 1970. Although in early 1971 only one general strike was held (on 7 April), a number of plant-level disputes occurred -- for example, at Pirelli (tires), Fiat (motor vehicles), and Zanussi (domestic appliances) -- and various trade groups such as the Roman restaurant owners and garbage collectors held localized strikes.

13. In addition to strikes, the reduction of working hours under 1969 labor contracts (many industrial sectors began moving from a 44-hour work week toward a 40-hour week) and a rise in industrial absenteeism cut into man-hours worked last year. Absenteeism -- estimated at around 7% of the industrial labor force daily in 1967 -- went up to an estimated 10% a day

3. *The 1967 Legge Ponte put strict limits on the price paid for expropriated land and the density of construction per acre. Because the law did not come into operation until the fall of 1969, it set off a frenzied stampede to register projects before that time.*

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Table 2

Italy: Business Survey ResultsPercent of Firms Anticipating Indicated ConditionsDate of Survey

	<u>New Orders</u>		
	<u>Increase</u>	<u>No Change</u>	<u>Decrease</u>
March 1970	23	69	8
August 1970	22	57	21
October 1970	19	58	23
December 1970	17	60	23
February 1971	23	56	21
March 1971	16	59	25
May 1971	12	53	35

	<u>Production</u>		
	<u>Increase</u>	<u>No Change</u>	<u>Decrease</u>
March 1970	32	62	6
August 1970	26	62	12
October 1970	16	64	20
December 1970	20	62	18
February 1971	25	57	18
March 1971	17	63	20
May 1971	11	63	26

	<u>General Trends in the Economy</u>		
	<u>Favorable</u>	<u>Stationary</u>	<u>Unfavorable</u>
March 1970	20	59	21
August 1970	12	66	22
October 1970	10	68	22
December 1970	13	60	27
February 1971	5	64	31
March 1971	6	54	40
May 1971	1	47	52

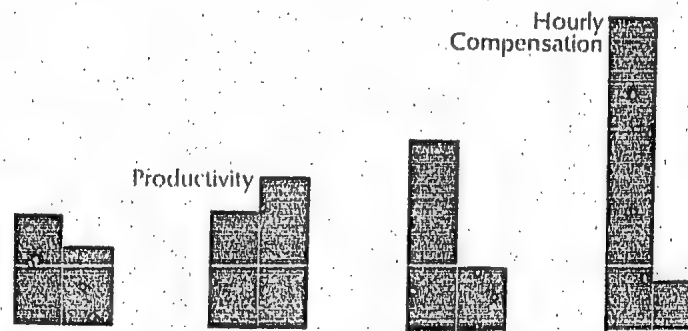
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in 1970, with a few firms at significantly higher levels. In late 1970 the rate for Alfa Romeo, the state automobile producer, reached 18%. 4/

14. Strikes and absenteeism contribute to lower output not only through the decrease in man-hours worked but also by a sharp drop in productivity (see Figure 2). Output per man-hour in manufacturing rose less than 3.5% on the average during 1969-70, compared with an average of 6.5% annually in 1961-68. But, while productivity growth was falling, large wage settlements in 1969-70 sharply hiked employee hourly compensation. For example, the minimum wage for an industrial worker (excluding his family allowance) went up 21% in 1970; in a few industries such as chemicals the rise was as much as 32%.

Italy: Annual Growth of Employee Compensation and Productivity per Man-hour in Manufacturing



*Productivity estimate based on revised 1969 data
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4. The rise in absenteeism is related to implementation of the Statute on Workers' Rights in mid-1970. The Statute, among other things, prevents firms from carrying out their own checks on employees claiming sick-leave; the company must accept a doctor's note as proof or have a state doctor investigate. Since few state doctors are available and apparently it is easy to obtain (or forge) a doctor's signature, effective checks on the worker's veracity are nil. The virtual elimination of checks along with better sick leave allowances awarded in recent labor contracts has apparently appealed to the workers' baser instincts.

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15. The surge in compensation per man-hour that resulted from large wage increases plus a drop in productivity growth produced a severe profit squeeze. While perhaps an extreme example, Fiat's net profits (after taxes) in 1970 fell to 16% of the 1968 level. The profit squeeze, by reducing firms' retained earnings (the major source of funds for private investment) at a time when interest rates were very high, 5/ deterred investment in labor-saving equipment. Small and medium-sized firms, which have a more difficult time obtaining and paying for credit, were especially hard hit. This profit squeeze exacerbated difficulties already apparent in branches of industry such as construction, textiles, and chemicals and generally dampened investment demand.

16. Political uncertainties, by contributing to low investor confidence and expectations, have also been major factors underlying slack demand. In addition to facing a shaky short-term general economic outlook, uncertain labor prospects, and pending tax-reform legislation, businessmen recently have been particularly concerned about government instability and the possibility of increased Communist influence on government policy. More immediately adding to uncertain political prospects is an upcoming presidential election and an autumn legislative slate in parliament containing controversial bills sure to increase coalition strains. Moreover, the state's gradual takeover of Montedison 6/ has revived some fears of further government intrusion into the private sector.

17. The pending tax reform bill has probably also deterred some investors. 7/ The bill is designed to cut down on the number of taxes paid and to discourage evasion through stiffer penalties, a computerized central tax registry, and introduction of a value added tax (VAT) system. The VAT will require the keeping of more detailed accounts and make tax evasion substantially more difficult than under the current turnover tax system. Tax evasion, however, has probably provided large -- if illegal -- subsidies to many firms. To the extent that tax reform cuts into "unreported" profits, it will tend to have an immediate adverse effect on investment.

5. Interest rates, kept at levels relatively low by international standards from 1965 to mid-1969, were allowed to rise substantially to deter massive capital outflows in the latter year. During 1970, net capital outflows abated considerably, and in early 1971, interest rates were allowed to fall somewhat.

6. The takeover was accomplished by ENI (Ente Nazionale Idrocarburi) purchases of Montedison stock beginning in 1968. ENI is rumored to own 44% of the outstanding shares of Montedison, and Eugenio Cefis (formerly head of ENI) has been appointed Montedison's president.

7. The tax reform should be legislated early this fall. Italy has an EC commitment to implement the value-added tax system on 1 January 1972.

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CONFIDENTIALThe Emergency Measures

18. To prevent present weaknesses from plunging the economy into a full-scale recession, the government issued five decree laws on 3 July. The laws were effective immediately, but still require parliamentary approval by early September. These measures, aimed largely at reviving investment demand, followed several aids legislated earlier this year to help specific industrial sectors.

19. The new laws will make large amounts of funds available. The budgetary cost of the entire package is estimated at \$900 million over the next 18 months (heavily weighted toward the first six months) and an additional \$300 million after 1972. The authorizations in several laws are temporary because Rome anticipates enlarged public expenditures on social reform programs beginning in 1972 and fears that too large an accumulation of expansionary programs would seriously aggravate price pressures.

20. The decrees are broad in scope and range from aid to industry to increased funding for agriculture. The first law covers credits for new investments (estimated at \$200 million). Existing programs to provide subsidized interest rates for loans to small and medium-sized firms and artisan ventures have been increased. Funds are also allotted specifically to help the merchant marine, the fishing industry, and the financing of exports and loans to less developed countries. A second decree provides more funds for interest rate subsidies on agricultural loans (\$62 million). Yet another allots an additional \$80 million to the special financial institution, *Istituto Mobiliare Italiano*, to aid applied industrial research. The fourth decree law -- applicable to firms with fewer than 300 employees or the first 300 employees for firms with fewer than 500 workers -- is one of the most important. It reduces for one year the employers' social security contributions by an amount equal to 5% of gross wages. The estimated budgetary cost of this decree law is \$320 million. The last of the decree laws allows the government to assume 30% of the social security charges of firms located in the South until the end of 1980 at an estimated budget cost of \$240 million. ^{8/} Finally, the package also contained a presidential decree allotting \$320 million to the Finance Ministry to speed up tax rebates on exports.

21. The Council of Ministers also approved an important amendment to the tax reform bill currently being debated in the Senate. The amendment provides discretionary authority for the government to issue decrees allowing

^{8/} A previous incentive program provided for 20% relief to the end of 1972.

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rebate of the cascade-type turnover tax (the IGE) during specified periods prior to introduction of the new VAT system: on purchases of capital equipment and plant construction, six months; on purchases of raw materials, four months; and on purchases by general commercial firms, two months. This amendment is designed to avert business postponement of investment and inventory accumulation until introduction of the VAT system (which exempts capital good purchases).

22. The full impact on investment and production of the measures in this anti-recessionary package will not be felt until late in the year. Several laws -- such as the one easing employers' social security contributions for firms in the South -- will immediately improve the self-financing ability of many companies, but the provision of better loan terms and other incentives will take effect slowly. In addition, the IGE rebate amendment will not go into effect until the tax reform bill is approved and a schedule established for implementation of the VAT, and some investors may delay until the rebate is guaranteed.

23. Several measures legislated earlier this year were aimed basically at reviving investment demand in specific sectors. To aid the oil industry -- hard pressed by higher crude oil costs resulting from recent Near Eastern oil agreements -- the government allowed refiners to increase prices. To avoid renewed inflationary pressures, however, the government at the same time lowered the excise tax on oil products (the tax on gasoline had been increased in 1970 to help raise revenue for the government's reform program). In May 1971 the government pushed an emergency housing bill through parliament while the broader housing reform bill awaited Senate approval. The emergency bill provides some \$16 million in interest rate subsidies for private housing mortgages, extensions of various expired tax exemptions, and simplification of authorization and expenditure procedures for various types of public works construction.

24. The recent decree laws and the earlier aids to industry have caused increased tensions within the Center-Left coalition government. Already strained over economic issues -- such as the timing and financial coverage of various social reforms (particularly housing), the tax reform, and the appointment of a new president for ENI and officers for other state enterprises -- coalition tensions were exacerbated by discussion over the type of emergency measures to take. Social Democrat Finance Minister Preti and some other Social Democrats, most Republican Party members, and assorted others from various parties agreed that the economy needed stimulation but were opposed to any short-term measures that would further increase the government's operating deficit and require additional inflationary financing. Socialist Budget Minister Giolitti, Christian-Democrat Treasury Minister Ferrari-Aggradi, and Governor Carli of the Bank of Italy,

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however, felt that an immediate injection of funds into the economy was needed to avert a recession which would ultimately endanger the social reform program.

Prospects

25. The emergency decree laws, together with earlier legislation, should provide considerable stimulus to the economy by late autumn. Full economic recovery, however, depends on a more peaceful labor climate, more normal production schedules, and the absence of major political disturbance. Foreign demand for Italy's goods and services, moreover, must remain adequate. The decree laws provide the means to finance economic recovery, but these other conditions must exist if business is to take full advantage of the new investment incentives.

26. Budget Minister Giolitti has said that industrial output must grow 6% and investment rise by \$800 million in the second half of 1971 to effect economic recovery. Such performance would imply an economic growth rate of 3% at least for the year as a whole. Although adequate capacity is available in most industries and the decree laws provide an incentive for increased investment in anticipation of future needs, these are ambitious targets for a country still experiencing abnormal strike activity as well as facing a controversial legislative schedule in parliament this fall and a presidential election in December that promises to exacerbate coalition strains. If these factors deter meeting production and investment targets, then the year's economic growth could be as little as 1% to 2%. This would be the poorest showing Italy has made since 1964 and considerably less growth than is needed to help close the income gap that exists between Italy and other industrial countries.

27. While unlikely to return to pre-1969 levels in the short-run, the strike incidence will probably continue to decline this year. Labor union leaders estimate that Italy lost 63 million man-hours of work to strikes in the first half of 1971. This represents only 67% of the time lost during the same period last year, but remains well above pre-1969 levels. The strike incidence could decline even further in the second half of the year. Several important plant-level disputes (for example, the strikes at Fiat and at Zanussi) were settled in mid-June, and resumption of more normal production schedules at these companies should help boost output in the transportation equipment and the machinery sectors. Moreover, workers seem somewhat disenchanted with "social reform" strikes which cut into their take-home pay. They are unlikely to support a major outbreak of general strikes unless the government drastically reneges on its social reform promises - an unlikely development. Sporadic, localized strikes by various interest groups to protest the VAT or to demand plant-level changes, however, will probably continue to occur.

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28. Foreign demand for Italian goods and services had been adequate if not spectacular in the first part of 1971, and current trends will probably continue. The value of merchandise exports rose 14.5% in the first five months of 1971 compared with the same period last year; perhaps one-half to one-fourth of the increase represented price changes. The new decree laws, by partly offsetting the rise in industrial labor costs of the past year, should help prevent a precipitous rise in export prices through the rest of the year, keeping Italy still relatively competitive abroad and thus maintaining adequate foreign demand to support domestic production. 9/ Tourist receipts, an important economic stimulant, have performed less well, rising only 5.0% in the first five months of the year relative to the same period last year. Although the sluggish growth of tourist receipts represents in part a trend in tourism away from Italy and to other Mediterranean countries, it also reflects the dissatisfaction of tourists over the effects of strikes on their accommodations, dining, museum visiting, and transportation within Italy. As the strike incidence falls, some recovery should be expected in tourist receipts.

29. The investment programs of state enterprises will be a continuing source of support for investment throughout the rest of the year. Firms owned or controlled by the State were expected to increase their investment 20% this year, and the electric power agency plans to continue its expansion program. Such organizations (exclusive of Montedison) together account for about 15% of total fixed investment and constitute an important stabilizing force in the economy.

30. Unless political tensions threaten a renewal of capital flight later this year, recovery of investment spending may be facilitated by a further easing in interest rates. Italian short-term and long-term interest rates are currently higher than in most West European countries, the United States, and the Eurodollar market. An easing in domestic rates, together with the increase in interest rate subsidy funds included in the new decree laws, would provide a further spur to investment.

9. Recent indications that the Italian government may exercise self-restraints over exports of leather shoes to the United States (2% of total Italian exports in 1970) through a new visa system for shoes do not conflict with the goal of maintaining strong foreign demand. Such actions would be intended to avert even more stringent controls imposed through protectionist US legislation.

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31. The government's relatively quick implementation of emergency measures (several months after definite signs of slowdown compared with fiscal policy decision delays of a year in the 1963-65 period) reflects political sensitivity to the uneasy social climate which the government - by its own lack of cohesion and consequent procrastination in decision-making - has helped create. Colombo's issuance of two major policy packages within the space of a year -- despite the strains they imposed on inter-coalition relations -- underlines the gravity of the social and labor unrest in Italy. 10/ Moreover, these actions indicate official recognition that the government's position may be too shaky to survive a major economic crisis.

10. Colombo issued a decretone in August 1970, shortly upon assuming office as Prime Minister. The last fiscal package, approved by Parliament in December 1970 after heated debate, was intended to raise revenue to cover deficits in welfare organizations, thus paving the way for health reform, and to help dampen inflationary trends.

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